



Simply Treasury

WHITE PAPER

FOCUS

**TMS ARE NOT
SUFFICIENTLY TAILORED
TO FULLY MANAGE FOREIGN
EXCHANGE RISKS**

SPOTLIGHT

VOICES OF THE INDUSTRY

MARKET RISKS AND FX REMAIN TOP PRIORITIES FOR EVERY TREASURER

“How to optimize your FX management processes is critical as this risk remains, in general, highly manually managed. According to recent surveys, we saw market risks (including FX risk) remains highly ranked among treasury priorities”.

Karen Vanden Driessche, Head of Treasury at ONTEX

TMS ARE NOT SIZED TO COVER ALL FX MANAGEMENT REQUIREMENTS

“Are TMSs designed to perfectly cover all FX management processes and to fully automate them is a key question to address. We believe that despite broad functionalities they are not covering all areas of the management of foreign currencies. Therefore, often MNC's must develop additional solutions on EXCEL spreadsheets, which are not robust at all”.

François Masquelier, Chair of EACT

IDENTIFICATION OF UNDERLYING RISKS IS MORE IMPORTANT THAN HEDGING IT

“More than ever, the refined treasury and market risk management are crucial for any multinational company. Not fully automating FX management would be a major risk. The art is not to hedge a risk but to identify it immediately and buy a financial instrument to hedge it automatically to preserve the operating margin”.

Marco Pescarolo, Head of Treasury at FERRERO



François
Masquelier

Chairman of Luxembourg Treasury Association,
ATEL and Vice-Chairman of EACT

INTRODUCTION



The recent health and financial crises, notably reactivated by the war in Ukraine, have demonstrated that currency risk management is an essential pillar of global cash management for all multinational companies. It is vital to protect operating profit margins as closely as possible, and in these troubled economic times, more so than ever. Efficiency can only come from centralized FX (Foreign Currency) management by treasury experts, fully automated from the identification of an underlying foreign exchange risk, through the purchase of an OTC (Over the Counter) hedging instruments, to the final settlement of those hedging instruments, to the payments / receipts of the foreign currency amounts. How-

ever, one might think that a Treasury Center equipped with a good Treasury Management System (i.e., “best-in-class” TMS) is perfectly capable of managing this risk. However, it turns out that TMS's are not able to completely manage the foreign exchange risk chain from its identification at the operational level, to the final settlement at the end of the day. TMS can at best manage the execution part of the currency hedge and the post-trade part until its settlement. On the other hand, the upstream part, i.e., pre-trade phase, remains hopelessly forgotten and neglected. This is the reason why foreign exchange risk management automation solutions have emerged and ideally complement TMS's. We will explain how and why.

KEY FIGURES



FX RISK PRIORITIZED BY TREASURERS

FX & market risk is ranked

#4th

by European Treasurers, while **digital transformation is ranked #2nd**, just behind cash-flow forecasting (which obviously cover also foreign currencies future flows).

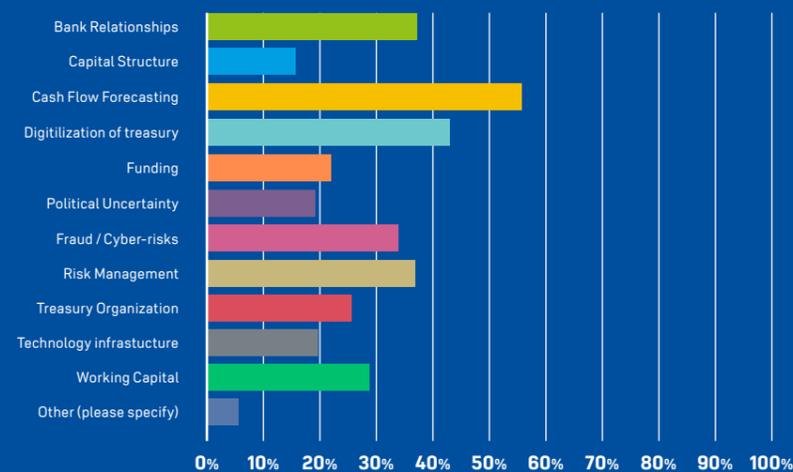
For treasurers worldwide, the next few years will signal a **movement towards newer technologies** as they **seek to enhance efficiency through greater automation**.

38%

of corporate treasurers are looking to change or implement a new TMS within the next 2 years and **over 80% are planning to do this to increase of automation and improve cash visibility**.

(Source ION survey 2022 the global treasurer)

Q2 WHICH OF THE FOLLOWING ARE LIKELY TO BE YOUR MAJOR PRIORITIES OVER THE NEXT 12 TO 24 MONTHS? PLEASE CHOOSE 3.



“ The coming years will signal a clear movement towards newer technologies as treasurers seek to enhance efficiency through further automation. ”

François Masquelier, Chair of EACT

TOP 3

KEY DRIVERS TO UPGRADE EXISTING IT ARCHITECTURE

(Source: "The Global Treasurer" / ION survey 2022)

1. Automation of manual processes
2. Consolidation of disparate systems (including XL sheets)
3. Cash visibility and optimization

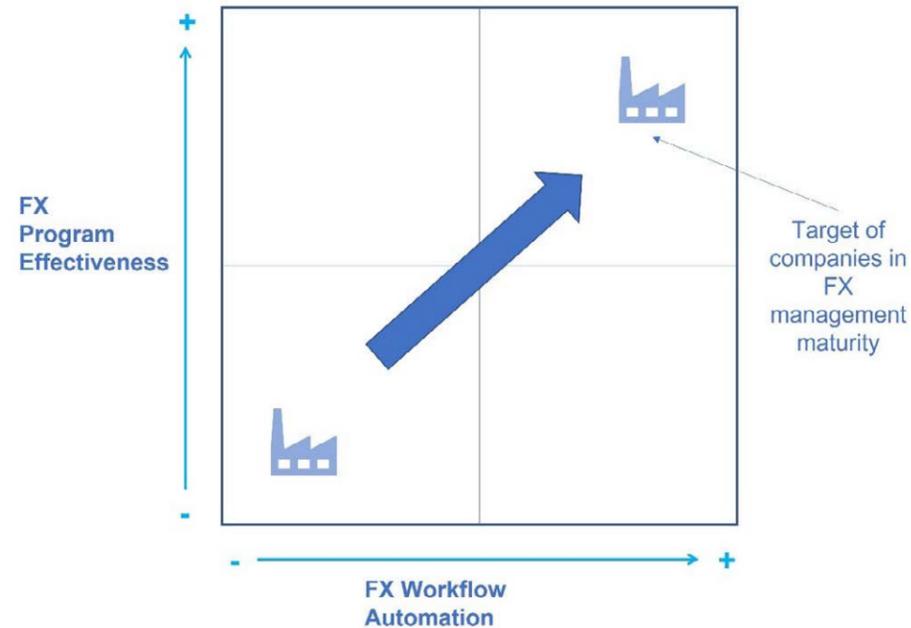
EARLY IDENTIFICATION OF FX RISKS

Identifying underlying FX exposures within a business remains one of the most challenging issues a treasurer can face. To succeed, treasury must collect across multiple geographic areas the underlying exposures, coming from operating activities (e.g., sale of goods and products, purchase of raw material, delivery of services, etc...). Coordination and clear policies are required to properly consolidate exposures and manage them. It is essential to collect whole exposures in (foreign) currencies, to analyze them and consolidate in real-time before applying any hedging strategy. In most MNCs, CFOs work with budget rates, which while creating many benefits can also relegate currency risk to that of a background issue for many in the business. The policy design and implementation to be effective is often a challenging process.

To have a comprehensive overview or mapping of all FX exposures, it is necessary, to have IT tools to collect and consolidate exposures, given sometimes variety of business divisions with different patterns. And when such a toll exists it is not interfaced with the TMS. It explains the highly manual part of the pre-trade phase. The full picture is essential, with fair timing for incoming/outgoing flows, as the time slots will determine the hedging and because of swap points the final costs. The 2 components are both important: how much and when? Time is a real issue in FX. The faster you get access to the pieces of information, the better your hedging will be. It is also essential to track exchange rates used for booking (to mitigate impacts under IFRS9).

What is also often missing is a clear, transparent, and efficient collaboration between operations and treasury. Such an excellent cooperation could prevent lots of issues faced. By understanding the underlying business, treasury can better advice it on how to optimize hedging and protect margins. Eventually, depending on the industry, especially if B2C businesses, the amounts of daily exposures could be individually small and collectively high. The one-to-one recommended approach can only be done is processes are automated accordingly. In practice, we all know that natural hedging and macro hedging (although possible under IFRS) remain rather theoretical. (NB: here we only focus on the transactional risks and let aside the translation risk which requires a different treatment, if applied).

VALUE OF CURRENCY MANAGEMENT AUTOMATION



MISSING PIECES FOR EFFICIENT FX MANAGEMENT IN TMS TOOLS

It is interesting to ask the question of whether a TMS can perfectly and completely cover all the functions necessary for optimal and automated FX management. At first glance, we would be tempted to answer that obviously any TMS, worthy of the name, must cover all the functionalities for optimized FX management. However, the truth is quite different and all of them have weaknesses or shortcomings that prevent a positive answer to our fundamental question. The TMS is a kind of database or directory in which the treasurer stores all financial transactions including FX hedges. It manages hedge accounting by creating hedging relationships, which will be monitored, revalued, and accounted for according to IFRS 9 rules. It also manages inter-company transactions with subsidiaries, which are those that are exposed to foreign exchange risks. The TMS manages what is commonly called "mirroring". For the most developed, they manage the accounting movements to be sent to the ERP. But if you look closely, it only manages the "trading" part (deal with the bank - external deal) mirrored by an internal deal (with the exposed subsidiary) and the "post-trade" part, until the hedging operation is settled upon delivery of the goods or services. The "pre-trade" part is totally hidden. However, one can only hedge judiciously what is identified, in time, regularly updated and stored in an operational system for the underlying exposures. Indeed, before buying 10 million USD against EUR, the treasurer makes sure of the underlying risk he/she intends to hedge (in accordance with the group's internal FX policy). The problem often comes from the management of two (or even more) databases, neither coordinated nor interfaced and yet having to work in tandem. The lack of perfect coordination increases the risk of under- or over-hedging, discrepancies, non-documentation of the risk, disqualification for hedge accounting, exchange rate results (favorable or unfavorable), etc... According to a recent TMI survey, 73% of respondents consider technology would help in the pre-trade phase of the workflow (forecasting and exposure collection).

MANAGEMENT OF THE OFF-BALANCE-SHEET ITEMS

The often "off-balance-sheet" part (e.g., cash-flow forecast, "highly probable transactions", firm commitment according to IAS39/IFRS9, etc.) must be managed in the TMS system while the underlying is not yet accounted for because it is still off-balance-sheet. The change of status in the life of an underlying exposure, from "forecast" to "highly probable" and then "firm commitment" (Off-Balance Sheet item) to finally end up with an amount invoiced or to be invoiced in foreign currency (i.e. On-Balance Sheet item), means that the accounting treatment will have to evolve to manage Cash-Flow Hedge and then Fair Value Hedge (even if this is theoretical for foreign exchange given the joint revaluation of the two legs on the balance sheet). This management of exposures is nevertheless essential and important because the hedging instrument and its usefulness or "raison d'être" depend on it. Without an underlying, or if the underlying disappears, the hedging relationship is extinguished. TMS are not interfaced with operational risk management tools and remain limited in terms of FX reporting. The idea of adding an intermediate module to optimize FX risk management makes sense.



Antoni Rami, Founder and Chief Growth Officer at KANTOX

INTERVIEW

Interview of Antoni Rami, Founder and Chief Growth Officer at KANTOX.

Could you explain what is missing in TMS solutions in terms of FX management and why because CFO's and Treasurers generally consider that a TMS should cover all FX processes and related operations?

In essence, TMSs are made for centralizing all the financial positions of a company (bank accounts, hedging instruments, etc...) and accounting for it (including Hedge Accounting features). As the strategic importance of FX grew due to globalization and increased volatility, only few TMSs have also developed the capability to centralize off-balance FX Exposures (in balance is more common) so hedges can be put in perspective (aka "hedge ratios" or "quotas"). The problem is, and it's a common flaw in Treasury processes that end up in financial losses and/or low value-added manual tasks, FX management goes much beyond centralizing and reporting exposures and hedges: it's about actually Managing it, meaning:

1) make sure that the information is the right one and arrives in a timely manner, ie that the exposure is captured as close as possible from inception and with the right reference, meaning that it's very different if the exposure starts with a rolling 24 month forward, a new sales order or a new balance sheet item, and the reference of this exposure might be the budget rate, the FX rate that the commercial team

used to embed it in the pricing or the accounting rate at which it will be referenced. Collecting it at the right moment and with the right reference is the key to manage exposure well and being able to prove so.

2) and more importantly trigger the necessary actions so that the FX Policy is properly followed, i.e., that the relationship between Exposures and Hedges corresponds to what has been defined as the optimal management approach; note that an action is not necessarily a 1-to-1 trade for each exposure: it can be

- monitor the market to optimize the forward points impacts (SL/TP), or
- schedule several trades for one unique exposure (layering), or
- group different exposures into a unique trade (micro-hedging), or
- link new exposures with existing exposures and/or hedges (e.g.: link a BSI exposure with the initial Forecast + its hedging instrument), etc...

Therefore, to summarize: TMS's actually "report" to Treasurers, but eventually the "Management" is up to the Treasurers themselves and that is why most treasurers do not use the TMS as the central tool to manage their FX risk and instead they use spreadsheets or only run balance sheet programs which might be falling very short in terms of achieving the real risk management goals of the company.



How can Currency Management Automation systems be coupled and interfaced with existing IT solutions, including TMS's?

A Currency Management Automation solution only makes sense when interfaced with the existing IT landscape of the company, since the key is to integrate with the systems where exposure is first recorded on the pre-trade (normally ERP, CRM, Planning tool...) with the execution platforms on the Trade phase (360T, FxAll, Bloomberg...) and with the TMS on the post-trade.

Citation

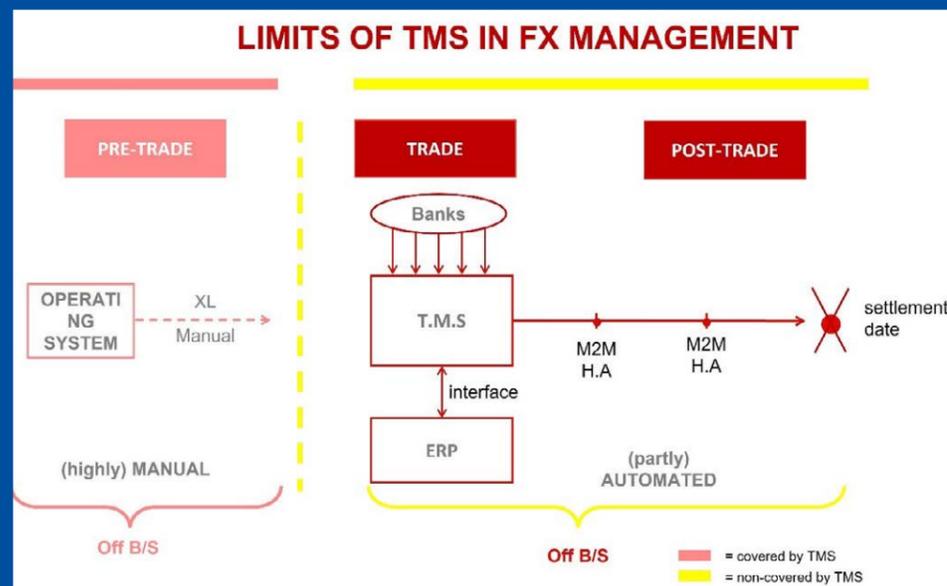


Should you have to give a piece of advice to treasurers facing inefficiencies in FX management, what would it be?

To challenge the status quo and apply critical thinking to your existing policy in general, not only to your existing processes. The most important is to build a policy that is really tailored



WHY IS OFTEN MISSING IN TMS FOR MANAGING FX RISKS?



ADDING A SPECIALIZED TOOL TO COMPLETE THE ARSENAL

The idea is to add a tool to manage the underlying risks or to interface this tool with the TMS. This layer of tools, such as KANTOX for example, allows to bridge the gap between the two worlds and to optimize the management of the exchange, while automating the often repeated and basic processes. APIs connections allow today to connect external systems to the TMS. The objective is to automate a process that is too often completely manual and done on XL, with all the relativity and lack of robustness of this wonderful tool from Microsoft.

TAKEAWAYS

- Make an in-depth assessment of your current FX management processes to identify manual ones, weaknesses, potential risks, and sources of inefficiencies
- Calculate the potential gains that a fully automated process would have generated.
- Don't think that a TMS will make every treasury operation and contemplate solutions to properly complement it.
- Automation enables efficiency, 24/7 FX management and hedging and one-to-one strategies for being more efficient.
- Never neglect the pre-trade phase, which is key to mitigate FX risks. The best execution of a hedging instrument never compensates a delay in reporting FX exposure.
- Automation is the best way to free up time of treasury teams to dedicate it to more added-value tasks and analytics. It is the way towards a more strategic role for treasury.

CONCLUSIONS

Focus on pricing of hedging instruments and best executions rather than on identification and reporting of exposures

In general, the treasurer focuses on the price of the hedging instrument and negotiates it fiercely, looking for the best spread or the best execution. The treasurer forgets that the best price will be the one closest to the rate at the time the exposure of the underlying starts. He/she also forgets that by automating the hedging process, when the amounts are small and frequent, he/she can optimize the hedge by individualizing it, systematically and immediately, instead of hedging it by aggregates (bulks). The approach is often very "siloed". Moreover, the treasurer sees FX automation as a threat to his/her work, whereas it is a relief that allows him/her to allocate resources to other more important tasks, such as analysis. Treasurers also lose a lot of time when preparing and producing FX related reports, especially IFRS 9 reports, because TMSs are quite standard and somewhat rigid in the preparation of these reports. The treasurer must then resort to his/her "worst" and best friend, the spreadsheet.

In the absence of an appropriate tool, the treasurer risks not perfectly respecting the established FX policy. Lack of resources, inadequate TMS, overly complicated processes, insufficient visibility on exposures, are the excuses most often given. They lead to poor coverage, too late, not aligned with coverage ratios, not compliant with the policy and ultimately ineffective. This can create frustration and dissatisfaction on both sides.

FX Risk Management remains challenging because it is too manual

Identifying underlying FX exposures within a business remains one of the most challenging issues a treasurer can face. To succeed, treasury must collect across multiple geographic areas the underlying exposures, coming from operating activities (e.g., sale of goods, purchase of goods, delivery of services, etc...). Coordination and clear policies are required to properly consolidate exposures and manage them. In most MNCs, CFOs work with budget rates, which while creating many benefits can also relegate currency risk to that of a background issue for many in

the business. The policy design and implementation to be effective is often a challenging process.

Perfect alignment of the management with the FX strategy

It seems to me that a good FX policy and strategy can only be validly implemented if one uses efficient and adequate tools to complement the TMS. In fact, some treasury software vendors have acquired companies to complement their products, proving that they do not cover all their customers' needs. The idea of complementing the existing to optimize FX management is vital, even more so since COVID crisis. Coordination and the ability to act immediately 24/7 is also essential. There are solutions, the so-called "CMA" (Currency Management Automation), such as KANTOX, which is a perfect accessory to any TMS and easy to implement. APIs allow to connect everything and to reach the FX Holy Grail, the Nirvana of hedging, the perfect automation, which also allows a dynamic and adjustable management at any time. Isn't it agility that the treasurer needs in these troubled times?



Simply Treasury

Francois Masquelier

Phone +352621278094

Email francois@simplytreasury.com

Address Résidence Soho NY (4A52)

1 rue de Chiny

L-1334 Luxembourg